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Veröffentlichungsversion / Published Version

Stellungnahme / comment

Empfohlene Zitierung / Suggested Citation:

Vallée, S. (2020). *Options for a European Recovery Fund*. (DGAP Commentary, 14). Berlin: Forschungsinstitut der Deutschen Gesellschaft für Auswärtige Politik e.V.. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-69197-9>

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Options for a European Recovery Fund



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On April 23, 2020, the European Council mandated the European Commission to work on a European Recovery Fund and to clarify its possible link with the Multiannual Financial Framework (MFF), the EU's long-term budget. Negotiations on the MFF for the period 2021-2027 were at an advanced state when the coronavirus-induced economic crisis hit the EU. Like so much else, the EU budget now needs to be adapted to meet new challenges in the wake of the health crisis.

In all likelihood, the European Commission will first issue a communication around May 14, 2020. It may suggest that the negotiations and legislative procedure surrounding the creation of a European Recovery Fund be fully embedded into the MFF and continue in that framework. The upside of doing this is that the recovery fund would be based in existing institutions and processes; the danger is that this would drag the process out and make the European Recovery Fund subject to endless bargaining.

The current debate about the EU's economic recovery from the pandemic

is characterized by a strong polarization around single issues, the most prominent being the question of jointly issued bonds on the funding side. On the expenditure side, the most divisive issue is the question of the relative amount of grants vs. loans. Both the size of the common borrowing as well as the amount of grants are central to the effectiveness of this future European Recovery Fund and should not be considered as a trade-off.

In order for the preparation of the MFF and the recovery fund to move forward in a productive way, EU decision-makers will have to carry out a sober assessment of the legal and technical options for raising the necessary funds and the respective pros and cons of different funding sources. It is important to note that the way the funds are used will be even more important than the way they are raised. This note focuses first on ways and means to raise a sizeable recovery fund and then describes succinctly the limitations that the selection of certain funding sources would impose on recovery fund spending.

WITHIN OR OUTSIDE THE MFF

There are several important choices for the EU to make. The first is whether it wants to create the recovery fund within the EU budget or outside of it. Some governments see advantages in linking the MFF and the recovery fund closely—they believe this would allow them to gain leverage in the struggle to reform the EU's most expensive expenditure policies, in particular the Common Agricultural Policy and Structural and Cohesion Policy, and negotiate a package deal. Also, this would allow existing funding tools of the MFF to be used.

But placing the recovery fund outside of the EU budget would provide far more flexibility and would certainly make it easier to negotiate. It would also allow a sub-group of Member States to proceed with it in the absence of unanimous agreement, which is required for agreements on the MFF. The EU urgently needs to agree to European Recovery Fund that would ensure a meaningful macroeconomic response, so even if the European Commission were to propose a close link between if not full integration in the MFF, a decoupling might eventually occur for the sake of expediency, in particular if the MFF negotiations end up in another deadlock.

Integrating the fund into the MFF

If the choice is made to proceed with a close link or integration of the recovery fund and the EU budget, the EU will have to solve fundamental questions that touch on the political nature of the EU budget and, more fundamentally, of the European Union.

- A first, seemingly technical question is whether the EU should only increase its annual resources ceiling temporarily in order to respond to the crisis via the use of “exceptional circumstances” (Art. 17 of the MFF regulation), or whether it should change the own re-

sources ceiling set in the Own Resources Decision, which in any case needs to be renewed for the period of the new Multiannual Financial Framework (2021–2027). Taking the latter option would imply that the European Council would have to raise the own resources ceiling, which was maintained at 1.23 percent of all the Member States' gross national income (GNI) for the two budgetary periods 2007–2013 and 2014–2020.

- Once there is an agreement to raise the own resources ceiling, the central question will be how to fund the increase. Currently, there are three categories of own resources: traditional own resources based on customs duties and until 2017 on levies on sugar production, the own resource based on value added tax (VAT), and the own resource based on gross national income (GNI). Other revenue sources include taxes paid by officials, fines imposed on firms by the Union, and interest on late payments. The key question now is whether the EU should fund the increase by getting higher contributions from Member States, according to the existing logic. An alternative would be to overcome the confederal nature of the EU budget, i.e. to ensure true, federal own resources in the form of VAT, corporate tax, plastic tax, or a levy on the EU emissions trading scheme. This is a rather fundamental question about the long-term future of the EU budget.

- It is thirdly necessary to ascertain the extent to which the EU is prepared to allow the EU budget to go into deficit. Formally speaking, as per Article 310 of the Treaty on the Functioning of the European Union (TFEU), all revenues and expenditures of the EU must appear in the budget and the budget must be balanced. But Article 311 stipulates that “the Union shall provide itself with the means necessary to attain its objectives and carry through its policies.” It would be an important departure to agree that, in response to

the crisis and as a means to deliver appropriate, sizeable, and timely solidarity, EU borrowing would count as EU revenues, thereby formally opening the way for the EU to run budget deficits. This would allow the EU to effectively spread the cost of the crisis over a longer time and would make the MFF a real budget with borrowing power, rather than a simple piggy bank.

- These discussions, however, cannot be disconnected from those on the liability incurred by the Member States in the process. The recent [introduction of the SURE framework](#) shows that the EU has been unable to consider lifting considerably the borrowing power of the EU with own resources and voluntary government guarantees to ensure the highest possible rating for the EU. An alternative to this model is the European Financial Stability Facility (EFSF): the great benefit of endowing a vehicle like the EFSF, governed by the EU, is that it has autonomous decision making and therefore the guarantees made to it do not count as public debt, unlike for example the paid-in capital to the ESM. Major points of contention here will be the size of the guarantees, and whether they are joint and several (each Member State is liable for the whole debt) or simply several (each Member State is only liable for each quota share), and finally how they are calculated. The EU BUDG directorate has so far had a very conservative approach to financial management. But the EU could certainly raise more debt without endangering its credit rating if it stopped limiting itself to borrowing no more than a maximum of the gap between the resources ceiling and actual expenditure, which implies that the EU should be able to pay back its entire debt stock over the seven year period of the MFF.

The maturity date of the borrowing will be important too. One option that deserves further exploration is the issuance of perpetual debt. The length

of the borrowing would be important to minimize the annual debt service of this borrowing. The longer the borrowing, the smaller the debt service. In the case of perpetual bonds, there is no reimbursement of the principal and therefore the debt service cost is

as low as possible. Positive examples for the use of perpetual bonds exist in post-war Britain as well as in the US. Some argue that under the use of 122 TFEU, which is meant to be for temporary emergencies, it would be difficult to justify perpetual borrowing. But

by this logic one could also argue that long-term borrowing of any sort would not be applicable to finance emergencies, which has not been the case before (see table 1).

TABLE 1 – OPTIONS FOR A EUROPEAN RECOVERY FUND BACKED BY THE EU BUDGET

Legal Basis in the TFEU	Purpose	Scope	Link to MFF	Use of funds
Art. 222	Emergency response to man-made or natural catastrophe. Catastrophes are considered to be large scale if the estimated direct cost of damage exceeds 3 billion euro or 0.6% of gross national income of the country concerned.	A Solidarity Fund is already in place and has been used in response to natural disasters or terrorist attack. As part of the EU coordinated package responding to the COVID-19 pandemic, the scope of the EU Solidarity Fund was extended by a modifying regulation adopted on 30 March 2020 . The amendment includes public health crises within the scope of the EUSF, to allow its mobilization, if needed, for the hardest hit Member States.	The financial resources necessary for the implementation of the Solidarity Clause should stay within the agreed annual expenditure limits and in accordance with the existing Union instruments and their financial ceilings (Art. 10 Decision 2014/415/EU).	The funds are used as grants
Art. 122	Extraordinary measures under “exceptional occurrences”. Art. 122.1 allows the EU to take measures appropriate to the economic situation “in the spirit of solidarity”, Art. 122.2 allows for ad hoc financial assistance to one or more member states.	The following conditions: a) the Member State should be in difficulties or should be seriously threatened with severe difficulties, b) these difficulties should be caused by natural disasters or exceptional occurrences and, c) these causes must be beyond the control of the Member State.	The financial assistance can be provided either via the EU budget—in which case, the instrument’s size would be limited by the expenditure ceiling—or by the total borrowing available under the own resources ceiling for payment appropriations. The alternative is to set up a new SPV, which could raise debt with bilateral Member States guarantees.	The funds can be used for loans or grants
Art. 352	The flexibility clause of the TFEU allows in principle the EU to exercise new powers consistent with the EU’s objectives after a proposal from the European Commission.	Special legislative procedure: a unanimous vote in the Council and the consent of the European Parliament.	Similar to 122, this can allow use of EU budget or creation of an ad hoc EU agency with its own resources.	Loans and/or grants
Art. 175	The proposal for a European Investment Stabilization Function was made by the Commission in May 2018 but never concluded.	Article 175(3) allows for the creation of an instrument supporting eligible public investment in Member States that are confronted with a large asymmetric shock with a view to strengthen cohesion.	The proposal envisaged loans to Member States from the EU are granted on the basis of MFF guarantees that would net out over time.	Loans only
Art. 172, 173 and 175	EU budget resources used in conjunction with the EIB to encourage private sector lending.	InvestEU is a program to support investment. It allows the leveraging of modest EU budget guarantees to facilitate EIB and private sector lending.	The program is an EU budget framework program that supports the European Investment Fund and the European Investment Banks.	Guarantees

TABLE 2 – OPTIONS FOR A EUROPEAN RECOVERY FUND OUTSIDE OF THE MFF

Legal Basis	Purpose	Scope	Link to MFF	Use of funds
Intergovernmental	EU Member States or a coalition thereof would be free to set up a vehicle with appropriate resources and guarantees.	Such a vehicle could be enshrined either in EU law (along the model of the Single Resolution Fund for example) or completely outside of the EU legal framework.	This intergovernmental arrangement would have no link to the MFF.	Member States would be free to offer loans and/or grants
Art. 136	Provides for financial assistance specifically linked to the safeguard and financial stability in the euro area.	The modification of Art. 136 under the simplified revision procedure in 2011 effectively limited EU powers to the provision of assistance for euro area stability under 122.2 and moved this responsibility to the ESM.	No link to the MFF. The ESM has its own paid and callable capital.	Loans only

Moving the recovery fund out of the EU budget

From today's perspective, it seems possible that the recovery fund will eventually be detached from the MFF so that it can move forward swiftly. There are at least two options for how the recovery fund could be implemented outside of the MFF (see table 2).

CONCLUSION

There are obvious pros and cons to both options for raising money for

the European Recovery Fund. Raising funds outside of the EU budget would be far more expedient and flexible, whereas doing it inside the EU budget would probably set a more important precedent and pave the way for further expansion down the line.

This brief overview shows that there are several ways for the EU to mobilize more resources in response to the corona crisis. Finding the right balance will require real political discussions and financial commitments. What is fundamentally at stake is not only the economic response and recovery but

also the future makeup of European financial solidarity and the EU's future autonomy. During the Eurocrisis, Member States and in particular Germany safeguarded national controls via intergovernmental instruments. This time, placing more fiscal resources in the hands of the EU budget would be a true step forward. However, while it is important to determine how these resources are raised, it will be even more important to decide how they are used. If it is merely to lend money to Member States, the EU's economic response will not be mutual enough to meet a common threat.

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Publisher

Deutsche Gesellschaft für
Auswärtige Politik e.V.

ISSN 1864-347

Editing Noah Gordon

Layout Luise Rombach

Design Concept: WeDo

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